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TAXATION OF TRUSTS – THE ATO 'SPEAKS'

As we highlighted in an earlier Tax Bulletin, in late March this year the High Court handed down an important decision regarding the taxation of the beneficiaries of trusts.

In Bamford's case the ATO had tried to limit the ability of the trustee of the Bamford Trust to give effect to the terms of the trust deed for that trust in determining how the beneficiaries of this trust should be taxed.

The High Court rejected the arguments used by the ATO and decided that the terms of the trust deed should prevail in determining how the beneficiaries should be assessed to tax.

In a victory for the ATO however, the High Court found against the taxpayers on the argument they had raised that they should only be assessed on the quantum of trust income that was distributed to them (rather than on the proportion of the trust income they were entitled to). In other words, the beneficiaries were assessed on a share of the taxable income of the trust in proportion to their entitlement to the trust income that was distributed by the trustee.

The ATO has now outlined the compliance approaches it will take as a result of the High Court decision. Importantly however, whilst (as expected) the ATO will withdraw Practice Statement PS LA 2005/1 (GA) - which allows a departure from the proportionate approach to tax the recipient of a capital gain even though they do not receive any other income - it will be withdrawn only with effect from the beginning of the 2010/11 tax year.

The technical outcomes for taxpayers per the ATO

The ATO accepts that the trustee of a trust can, where allowed by the trust deed, determine that any capital gains made by the trust can be treated as income for the purposes of determining whether a beneficiary is "presently entitled to a share of the income of the trust estate" (which is the key requirement for a beneficiary to be assessed rather than the trustee).

Secondly, because the High Court decided that a beneficiary's liability to tax is based on their proportionate interest in the income of the trust (rather than any particular dollar amount that has been distributed to them), the ATO agrees that beneficiaries may be taxed on more or less than they actually receive from a trust where there are differences - as is often the case - between the income of the trust as determined under the trust deed and the taxable income of the trust.

The practical outcomes for taxpayers per the ATO

To quote from the ATO Decision Impact Statement ("DIS") on the Bamford case, for "practical purposes [the decision in Bamford] means that:

- a provision of a trust instrument, or a trustee acting in accordance with a trust instrument, may treat the whole or part of a receipt as income of a period and it will thereby constitute 'income of the trust estate' for the purposes of section 97;

- if a trust instrument does not specify when a receipt is to be treated as income of a period, and the trustee does not have any special power to characterise receipts, then the question of whether the whole or part of a receipt constitutes 'income of the trust estate' for the purposes of section 97 will fall to be determined in accordance with the general presumptions of trust law;
- similarly, the provisions of a trust instrument, or a trustee acting in accordance with a trust instrument, may determine whether an outgoing is properly chargeable against the income of a period (absent which the question will fall to be determined in accordance with the general presumptions of trust law); and
- subject to the possible operation of provisions outside Division 6, the amount included in a beneficiary's assessable income under section 97 consists of an un-dissected or un-allocated proportionate share of the entirety of the [tax] net income."

Issues that remain uncertain according to the ATO

The ATO believes that a number of issues regarding the taxation of trusts remain uncertain despite the decision of the High Court in Bamford. Two of the issues that the ATO has identified as uncertain are particularly important in our view and, as the ATO has announced that it will be consulting with practitioners on these issues, we will be making submissions to the ATO in order to protect the interests of our clients.

The two issues that we believe are particularly important are, to quote from the DIS:

- "the effect for trust law purposes of provisions in trust instruments (or trustee determinations) which purport to equate the trust's distributable income with its [tax] net income where the [tax] net income includes notional amounts (eg. franking credits or deemed capital gains) or where the time at which income is recognised for tax purposes differs from the time at which it is recognised for trust accounting purposes (eg. where trust assets are accounted for at fair value);" and
- "how the statutory flow through provisions such as Subdivision 115-C of the ITAA 1997 (capital gains and trusts) and Subdivision 207-B of the ITAA 1997 (franking credits and trusts) interact with Division 6 given that a beneficiary's liability to be assessed on the [tax] net income of the trust under Division 6 may not correspond with the beneficiary's actual entitlement".

Our view on the first point is that trust law income is, post Bamford, whatever a particular trust deed states it to be. On the second point we believe that it is crucial that the ATO gives effect to the clear intent of Parliament that CGT treatment and franking credits should flow through a trust.

Rulings, Determinations and Practice Statements that the ATO will be withdrawing

The ATO will be withdrawing the following rulings and practice statements:

- TR 95/29: Income tax: Division 16 - Applicability of averaging provisions to beneficiaries of trust estates carrying on a business of primary production;
- Taxation Ruling No. IT 331: Adjustments to estate income as returned to arrive at net income of estate for the purposes of section 95; and
- PS LA 2005/1 (GA): Taxation of capital gains of a trust.

In recognition of the fact that trustees and beneficiaries may have already relied on the above rulings and practice statements in respect of the 2009/10 income year they will however, only be withdrawn with effect from the beginning of the 2010/11 income year.

The ATO will also be withdrawing TR 92/13 (Trust dividends and franking) on the basis that it concerns provisions which are no longer in force - i.e. the old dividend imputation provisions. Importantly though, as the ATO recognises that for 2009/10 and earlier income years taxpayers may have relied on TR 92/13 as a guide to how the ATO would seek to apply the current imputation rules, the ATO will not disturb tax returns that have been "reasonably prepared" on a basis consistent with TR 92/13.

What compliance action will the ATO now be taking?

As (pre Bamford) there was considerable uncertainty about the taxation of trusts, the ATO acknowledges that some taxpayers will have lodged tax returns on the basis of views that (post Bamford) may now be wrong. Accordingly, in a companion Practice Statement to the Bamford DIS it has instructed its staff undertaking compliance activities in respect of the 2009/10 and earlier income years not to select cases for active compliance just to correct such errors.

However, the Practice Statement goes on to state that if there is a deliberate attempt to exploit the trust provisions or cases are selected for other reasons (for example, because there is a dispute about the taxable income of a trust), any adjustments must be made on the basis of the law as explained in Bamford.

Our view on the practical consequences for taxpayers

As we have noted before, the same set of numbers can give rise to a significantly different tax outcome dependent on whether and how income is defined in the Trust Deed and what other powers the Trustee may have in determining the distributable income of the trust. In particular, in some circumstances the trustee can end up being assessed at 46.5% even where an amount has been distributed to the beneficiaries.

The types of situation that can cause difficulty include the following:

- No income but a capital gain.
- Distributing the income to one beneficiary but the capital gain to another.
- No book profit but taxable income - e.g. due to booking mark to market differences and recognising provisions for trust accounting purposes.
- Other book to tax differences - e.g. because a trustee is required to make good a deficiency out of current year income.

Overlaying each of these situations is the Trust Deed. The following are the common scenarios:

1. the Trust Deed is silent in relation to the meaning of income;
2. the Trust Deed allows the trustee to adopt the normal meaning of income or to otherwise determine what is included in income and/or capital; or
3. the Trust Deed defines income to be equivalent to taxable income.

Based on our view of the Bamford case, where the Trust Deed falls into either scenario 2 or 3 there should be no trustee assessment where the trustee resolves to distribute 100% of the income. However, there may be problems if a Trust Deed does not define income and there is taxable income but no accounting profit - this could give rise to a trustee assessment.

The Bamford case and the ATO DIS also reiterate that the correct approach to present entitlement is the proportionate approach. In other words, beneficiaries will be entitled to a share of taxable income in proportion to their entitlement to the trust income that has been distributed by the trustee.

Finally, 2009/10 will be the last tax year in which the ATO will allow the Capital Beneficiary approach in PS LA 2005/1 (GA) to be adopted - as noted above, this PSLA allows a departure from the proportionate approach to tax the recipient of a capital gain even though they did not receive any income. (Note: as a practical matter, the effect (if any) that the withdrawal of this PSLA may have will depend on the terms of the relevant trust deed. For example, if a trust deed has been drafted so that capital gains may be included in the definition of trust income - i.e. as in Bamford's case - the withdrawal of the PSLA may have little impact).

What action should you now be taking?

- Review your Trust Deed(s) to determine the definition of income and what other powers the Trustee may have in determining the distributable income of the trust.
- Determine any likely book to tax differences.
- Work out if there are likely to be any net capital gains derived in the foreseeable future.
- If 'income' is not defined in the Trust Deed, it may be desirable to amend the Trust Deed to give the trustee the discretion to either determine income according to ordinary concepts or to allow the trustee to specifically determine what is to be income and what is to be capital.
- Any Minute distributing income should refer to the specific income clause. For example, if the trustee has a discretion to determine what amounts are income or capital, the Distribution Minute should refer to the particular clause(s) in the Trust Deed (including any that permit the trustee to characterise amounts as income or capital) saying that income has been determined in accordance with Clause X etc.
- Be conscious of the proportionate theory when distributing capital and/or streaming classes of income - i.e. subject to specific provisions like Subdivision 115-C (capital gains and trusts) and Subdivision 207-B (franking credits and trusts), the strict application of the proportional approach may mean that it will be difficult to 'stream' particular amounts to particular beneficiaries.

If in doubt, discuss your issue with Pitcher Partners - misapplication of the provisions of a Trust Deed or a misworded Minute can give rise to a significant liability to the trustee.

FURTHER INFORMATION

Please ask your regular Pitcher Partners tax contact for further details on the issues raised in this Tax Bulletin.

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